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Bankruptcy Litigation

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Equitable Mootness[1]

I. Equitable Mootness is a judge-made doctrine and is seemingly contrary to the principle that federal courts shouldn't (or can't) decline jurisdiction. Should equitable mootness ever be available to save a confirmed plan?

A. *Is it fair to deprive an appellant of a substantive review on the merits if it's done everything it could to preserve those rights; that is, object to the plan; seek a stay from the District Court and then the Court of Appeals; move for an expedited appeal?*

B. *Unlike abstention, where there's another forum to try and review the claim, here the claim will never be reviewed. Is this okay?*

C. *What if the plan does something that is, on its face, at least, contrary to the Bankruptcy Code (e.g., improper classification; violation of absolute priority; etc.) but is completely consummated before the appeal is heard?*

D. *More generally, shouldn't the appellate court address the merits first and only then consider the equities?*

II. To what degree should appellate courts take in to account the impact of a reversal?

A. *on creditors who agreed to compromise their claims in order to reach a consensus plan?*

B. *on plan sponsors and proponents who invested in and are financing the plan?*

C. *on traders who've bought and sold the debtor's securities based on a likely confirmation?*

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1. Compiled by Michael Luskin (Luskin, Stern & Eisler LLP) and Chris Gartman (Hughes Hubbard & Reed LLP) using, in part, material prepared by the American Bankruptcy Institute Law Review for the 2017 Hon. Conrad B. Duberstein Bankruptcy Moot Court Competition and by Martin Bienenstock (Proskauer).

III. What if the confirmation order is reversed? What happens next? – must there be a new plan? Modification and a new vote? What of payments already made, assets transferred, etc.?

IV. The Bankruptcy Code immunizes some actions from efforts to "unscramble" following a successful appeal – e.g., advances under an interim DIP order and § 363 sales made in good faith. Should the doctrine be used to make confirmation orders similarly immune, absent specific statutory exceptions like these? If they are, does this mean that important Bankruptcy Court decisions will never be subject to review by an Article III judge? Is that okay?

V. How is the appellate court supposed to determine "mootness"? Must the plan objector make a record on the inability to "unscramble" at the confirmation hearing? Isn't this highly speculative – what can/cannot be undone? What claims can/cannot be brought? Who should bear the burden of proof? Will Bankruptcy Judges allow these issues to be tried at confirmation? Should they?

Selected Recent Equitable Mootness Cases

I. Cases Dismissed As Equitably Moot

A. *Bennett v. Jefferson County, Alabama*, 899 F.3d 1240 (11th Cir. 2018)

1. Facts

In 2011, Jefferson County, Alabama filed a Chapter 9 petition to address, among other things, over $3 billion in sewer warrant debt from issuing sewer warrants. The County proposed a Chapter 9 plan that would retire the previously-issued sewer warrants in favor of new, publicly-marketed warrants, and locked warrant rate increases by County commissioners for 40 years. The County would be prevented from decreasing sewer rates in any particular year unless it could offset the decrease. A group of County ratepayers objected to the plan. They argued that the plan raised state and federal constitutional issues – first, that the retiring of the old sewer warrants glossed over government corruption that caused the warrants to be issued in the first place, and second, that the plan's restriction on rate adjustments by County commissioners violated the ratepayers' due process rights and rights to vote. The Bankruptcy Court ultimately confirmed the plan over these objections, and retained jurisdiction over the life of the new sewer warrants.

2. Procedural Posture

The ratepayers filed a notice of appeal two days before the effective date of the plan, but they did not object to waiver of the

14-day stay of the Bankruptcy Court's confirmation order, nor did they seek a stay of the confirmation order pending their appeal.

The County moved to dismiss the appeal, arguing that it was equitably moot because the plan was already substantially consummated and the transactions detailed in the plan could not be unwound. The District Court disagreed, finding that equitable mootness cannot be applied to constitutional challenges to Chapter 9 plans. It also found that, even if equitable mootness could apply, the court would be able to grant relief to the ratepayers, and the ratepayers' failure to seek a stay did not necessarily make their claim moot.

3. Issue

Whether equitable mootness can apply to Chapter 9 cases and, if so, whether the ratepayers' appeal is equitably moot.

4. Holding

Yes, it can apply, and yes, it is moot.

5. Reasoning

The Court of Appeals found that no circuit had rejected equitable mootness outright. It reviewed prior decisions in which the Circuit found equitable mootness barred an appeal, and found the most important factor was whether allowing the appeal would impinge on actions taken by stakeholders in good faith reliance on a final and unstayed judgment. Because equitable mootness has no codification or limitation, but is guided by "principles," the court found that there was no reason why the doctrine could not apply in Chapter 9 bankruptcies. It disagreed with the ratepayers' argument that the court should refuse to bar constitutional appeals in Chapter 9 cases because allegations of constitutional violations could not excuse the appellant's procedural failures. Having decided that equitable mootness could apply in Chapter 9 cases, the court found that, because the ratepayers never sought a stay of the plan; the County and other stakeholders had acted in reliance on the confirmation order to take irreversible steps; and the locked rate increases were not per se constitutional rights violations, the ratepayers' appeal could be dismissed as equitably moot.

6. Cert. Denied

On March 4, 2019, the U.S. Supreme Court denied the ratepayers' cert. petition without explanation. The Supreme Court has now denied petitions for writs of certiorari in all appeals (totaling over a dozen) challenging the viability of the equitable mootness doctrine.

B. *In re City of Detroit,* 838 F.3d 792 (6th Cir. 2016)

1. Facts

The City of Detroit filed for municipal bankruptcy on July 18, 2013, pursuant to Chapter 9 of the Bankruptcy Code. At the time of filing, the City had over $18 billion in escalating debt and over 100,000 creditors, was bleeding cash and could not provide basic municipal services. At the heart of the City's reorganization plan was a settlement (dubbed the "Grand Bargain") under which the City received outside funding to pay off certain debts.

The plan was confirmed in November 2014 and became effective on December 10, 2014, and the City began implementing it immediately by, among other things, issuing $287.5 million in bonds and $720 million in new notes; irrevocably transferring all Detroit Institute of Art assets to a perpetual charitable trust; recouping substantial funds; transferring certain real property interests pursuant to separate settlement agreements incorporated in the plan; and implementing a two-year City budget. Pensioners who were forced to take a reduction in their payouts challenged the reduction.

2. Procedural Posture

Several pension fund holders appealed to the District Court challenging the reduction in their pensions and a release provision that prevented retirees from asserting claims against the State of Michigan. The city moved to dismiss the appeals as equitably moot. The District Court agreed, noting that appellants did not obtain a stay; the confirmed plan has been substantially consummated; and reversal of the plan would adversely impact third parties and the success of the plan.

3. Issue

Whether the pension fund holders' appeal is equitably moot.

4. Holding

Yes, it is moot.

5. Reasoning

The Court of Appeals analyzed equitable mootness under a three-part test: (1) whether a stay pending appeal was obtained; (2) whether the bankruptcy plan has been substantially consummated; and (3) whether the relief requested would significantly and irrevocably disrupt implementation of plan or disproportionately harm the reliance interests of parties in interest. 838 F.3d at 798. Pensioners' appeals of the Bankruptcy Court order confirming the Chapter 9 plan, which had the effect of reducing pension benefits, were equitably moot. This was because the plan had been substantially consummated: numerous significant actions had been undertaken or completed, many irreversible, in reliance on the plan, and where the relief that pensioners requested on appeal would necessarily rescind the bargain that was at the heart of the City's negotiated plan and would adversely affect countless third parties, including the entire City population. The Court did not regard this as a "close call." *Id.* at 799. The Court also noted that equitable mootness is a prudential doctrine that was not overruled by recent Supreme Court cases cutting back on prudential doctrines (e.g. *Lexmark*, 134 S. Ct. 1377 (2014)). *Id.* at 800.

6. Dissent

The dissent took a contrary view of Supreme Court precedent, also citing *Lexmark*, and wrote that the doctrine amounted to an abdication of the ability of an Article III court to review cases properly before it. *Id.* at 805-813.

C. *Beeman v. BGI Creditors' Liquidating Trust (In re BGI, Inc.)*, 772 F.3d 102 (2d Cir. 2014)

1. Facts

Borders Group Inc. entered liquidation shortly after filing for Chapter 11 protection in February 2011. As part of the liquidation, Borders stopped accepting gift cards and online purchases. Borders filed a plan of liquidation in November 2011, mailed notices of the claims bar date to all known creditors, and published a notice of the bar date and confirmation hearing in *The New York Times*. The plan was confirmed in December, with an effective date of January 12, 2012. Unredeemed gift card claimants moved to file untimely proofs of claim on January 4, 2012, arguing they did not receive adequate notice, and sought to certify a class of all Borders gift card holders. They did not seek a stay of the effective date. The Bankruptcy Court denied their motions, finding that they were "unknown" creditors who were only entitled to publication notice. The court found that the plan had already been substantially consummated, namely through a $17 million distribution to priority claimants, and that permitting late claims following this distribution would be "disastrous" on the remaining estate funds.

2. Procedural Posture

The gift card claimants appealed to the District Court. In October 2012, they sought a stay of interim distributions pending the appeal. The Bankruptcy Court denied this motion. The District Court then denied the claimants' appeal as equitably moot, finding the relief they sought would cause "drastic changes" to remaining creditor distributions. The gift card claimants then appealed to the Second Circuit.

3. Issue

Did the District Court abuse its discretion in determining the gift card claimants' appeals were equitably moot?

4. Ruling

No.

5. Reasoning

The Court of Appeals held as a matter of first impression that equitable mootness applied to chapter 11 liquidations as it does to restructurings, citing similar conclusions in other circuits. The court then determined that the District Court did not abuse its discretion in finding the plan was substantially consummated at this point, nor that the District Court did not abuse its discretion in finding two *Chateaugay* factors adverse to the gift card claimants' appeal. First, general unsecured creditors were not notified of the gift card claimants' appeal, and their appeal could wipe out all recovery to the unsecured creditors. Second, the gift card claimants did not pursue their appeal "with all due diligence," failing to object to plan confirmation or to seek a stay of the confirmation order.

D. *R2 Investments, LDC. v. Charter Communications, Inc. (In re Charter Communications, Inc.),* 691 F.3d 476 (2d Cir. 2012)

1. Facts

The Bankruptcy Court confirmed a chapter 11 plan and the indenture trustee for noteholders and a shareholder appealed claiming numerous errors including: (a) that without substantively consolidating the affiliated debtors the court allowed an impaired accepting class of one debtor to satisfy the requirement under Bankruptcy Code section 1129(a)(10) for all the debtors, 691 F.3d at 487-488, (b) that claims were gerrymandered into separate classes to create the impaired accepting class, 691 F.3d at 487, (c) that the debtors were valued as if they were one entity, *id*., (d) the grant of releases to nondebtors of creditor and shareholder claims against them, 691 F.3d at 480-481, 484. The Bankruptcy Court and District Court denied requests for a stay pending appeal. 691 F.3d at 481. The plan became effective with old stock being cancelled, new stock being issued, new notes replacing old notes, and warrants being granted to noteholders. 691 F.3d at 481. The District Court dismissed the appeal as equitably moot.

2. Issue

If relief can be granted, appellant diligently applied for a stay pending appeal, and many parties who would be effected by reversal are parties to the appeal, can the appeal still be dismissed as equitably moot?

3. Holding

Yes.

4. Rationale

"The bankruptcy court found that the compensation to Allen and the third-party releases were critical to the bargain that allowed Charter to successfully restructure and that undoing them, as the plaintiffs urge, would cut the heart out of the reorganization. Crediting multiple witnesses, it also found that Allen was in a unique position to create a successful arrangement because only through his forbearance of exchange rights and agreement to maintain voting power could Charter reinstate its senior debt and preserve valuable net operating losses. See

Findings of Fact, Conclusions of Law, and Order Confirming Debtors' Joint Plan of Reorganization ("Conf. Order") ¶¶ 32, 43; see also JA 462, 589, 605, 611. The releases, like the compensation, were important in inducing Allen to settle. See Conf. Order ¶ 32; see also JA 463, 589, 605, 611. In the face of witnesses representing that the releases and compensation were important to Allen, LDT and R2 can point to no evidence that the settlement consideration paid to Allen or the third-party releases were simply incidental to the bargain that was struck. Compare *In re Metromedia,* 416 F.3d at 145 (request to strike third-party releases equitably moot because "it was as likely as not that the bargain struck by the debtor and the released parties might have been different without the releases"), with *In re Cont'l Airlines,* 203 F.3d at 210-11 (appeal of third-party releases not equitably moot where there was "no evidence or arguments that Plaintiffs' appeal, if successful, would necessitate the reversal or unraveling of the entire plan of reorganization").

"Even if LDT and R2 are correct that the settlement consideration and releases are legally unsupportable, these provisions could not be excised without seriously threatening Charter's ability to re-emerge successfully from bankruptcy. Nor could the monetary relief requested be achieved by a quick, surgical change to the confirmation order. Allen may not be willing to give up the benefit he received from the Allen Settlement without also reneging on at least part of the benefit he bestowed on Charter. Thus the parties would have to enter renewed negotiations, casting uncertainty over Charter's operations until the issue's resolution. We therefore find no abuse of discretion in the district court's conclusion that these claims relating to the Allen Settlement are equitably moot." 691 F.3d at 486.

II. Case Refusing to Dismiss for Equitable Mootness

A. *In re Sneed Shipbuilding, Inc.,* 916 F.3d 405 (5th Cir. 2019)

1. Facts

Sneed Shipbuilding filed for bankruptcy in 2016. The bankruptcy progressed slowly after the Sneed trustee filed a complaint alleging fraudulent conversion of a company shipyard against the probate estate of the company's principal. This caused the debtor to approach conversion to Chapter 7, and resulted in the appointment of a chapter 11 trustee. To avoid liquidation, the trustee tried to sell the shipyard. A buyer, San Jac Marine, was willing to purchase only if the trustee resolved its dispute with the probate estate.

The trustee and the probate estate structured a settlement and sale of the shipyard to San Jac Marine. According to the terms, San Jac Marine would pay $15 million to Sneed. The trustee would use that money to ensure clean title on the shipyard. The probate estate would give up its claim to the shipyard in exchange for $8 million from the trustee. The Bankruptcy Court approved this settlement and sale in a final order. Unsecured creditor New Industries unsuccessfully objected to the $8 million disbursed to the probate estate, but did not seek a stay of the court's order approving the transaction.

2. <u>Procedural Posture</u>

New Industries appealed. The trustee asked the District Court to dismiss the appeal as equitably moot, but also as statutorily moot under 11 U.S.C § 363(m). The District Court dismissed the appeal but did not state under which doctrine of mootness it was deciding upon.

3. <u>Issue</u>

Was New Industries' appeal of their objection to the disbursement of trustee funds to the probate estate moot under equitable mootness or section 363(m) mootness?

4. <u>Ruling</u>

Not equitably moot, but statutorily moot under section 363(m).

5. <u>Reasoning</u>

The Court of Appeals was "more hesitant" to use equitable mootness than other circuits. It found that the doctrine is typically used at the post-confirmation stage, when a plan of reorganization is at least substantially consummated. Equitable mootness is sensible at this stage when appellate reversal might undermine the plan and the parties' reliance on the plan; but when no plan has been proposed, there has been no reliance on it. The Court of Appeals noted that some other circuits have used equitable mootness to review "messy" settlement agreements, but distinguished the settlement at hand as "not sufficiently complex." While a complex settlement might have substantial secondary effects on parties outside of the settlement, the court found no such situation here. However, it found that section 363(m) mootness could apply because the main concern under section 363(m) is to "encourage parties to bid for estate property." The court found that once a section 363 sale is approved and consummated, no court should be able to second-guess that sale. Although New Industries argued it was not challenging the sale itself, but only the disbursement of cash to the probate estate, the court found it could not separate the disbursement from the process of the sale.

B. *Matter of M.P.M. Silicones, LLC*, 874 F.3d 787 (2d Cir. 2017)

1. Facts

Between 2006 and 2012, Debtor Momentive Performance Materials USA LLC ("MPM") issued classes of subordinated notes, second lien notes, and senior secured notes. The senior secured notes were contractually entitled to a "make-whole" premium if MPM redeemed them prior to maturity. In 2014, MPM filed for Chapter 11, and later proposed a plan of reorganization. The subordinated noteholders and the senior secured noteholders, appellants in this case, opposed the plan. The subordinated noteholders would receive no recovery under the plan, and argued that they were not subordinated to the second lien notes. The senior secured notes opposed the plan because it did not pay them the make-whole premium and provided them with replacement notes with a lower interest rate than the market rate. The Bankruptcy Court confirmed the plan. During the automatic 14-day stay of the confirmation order, the appellants moved in the Bankruptcy and District Courts to extend the stay pending their appeal. Both courts denied these motions. The plan then became effective.

2. Procedural Posture

The appellants timely appealed the confirmation order to the District Court, which dismissed the appeal as equitably moot, and then to the Second Circuit. MPM claimed the appeal was equitably moot because the plan had been substantially consummated and the noteholders failed to show that the court could grant effective relief without substantial disruption to the plan or debilitating financial uncertainty.

3. Issue

Was the appeal equitably moot, even if the appellants timely filed their appeals and moved to extend the stay pending their appeals?

4. Ruling

No. The appeal was not equitably moot.

5. Reasoning

The Court of Appeals found that the relief sought by the appellants was too limited in scope, compared to the massive scale of MPM's reorganization, to pose a threat to the plan or unravel any intricate transactions. The subordinated noteholders only sought to reallocate recoveries between classes, and general unsecured claims were worth only two percent of the second lien noteholders' claims. The senior secured noteholders similarly only sought a higher interest rate on replacement notes. The court also emphasized that both classes of appellant noteholders promptly objected to the plan and sought a stay of the confirmation order.

C. *In re One2One Communications, LLC,* 805 F.3d 428 (3rd Cir. 2015)

1. Facts

One2One Communications (the debtor) was a billing services technology company. Appellant, Quad/Graphics Inc., held the single largest claim against the debtor and the debtor's CEO. The debtor filed a voluntary petition for relief under Chapter 11 in the Bankruptcy Court for the District of New Jersey. Beginning in September 2012, the debtor filed its first, second, and third amended plans of reorganization. The debtor filed a fourth amended plan of reorganization on January 25, 2013, under which a third party, One2One Holdings, LLC, would acquire an equity interest in the debtor. The plan incorporated a plan support agreement, which provided the plan sponsor with the exclusive right to purchase 100% of the debtor's equity for $200,000, and had the support of the Creditors' Committee. Quad/Graphics, the debtor's largest creditor, objected, arguing that the plan violated the absolute priority rule by allowing equity to keep its interests without paying unsecured creditors in full. On March 5, 2013, the plan was confirmed after a five-day trial; the confirmation order was automatically stayed for 14 days. Quad/Graphics moved for a stay pending appeal before the District Court (which denied the motion) and the Court of Appeals (which also denied). Quad/Graphics then moved for an injunction before the District Court (which the Court denied). The parties briefed the merits of the appeal, but the District Court never reached the merits because it granted the debtor's motion to dismiss the appeal as equitably moot on June 24, 2013.

2. Issue

Did the District Court abuse its discretion in deciding that the bankruptcy appeal was equitably moot?

3. Holdings

a. Short answer: Yes.

b. The Court of Appeals declined to revisit the Circuit's decision in *Continental*, saying only the Court sitting *en banc* could do so. It also held that the Supreme Court's decision in *Stern v. Marshall* did not bear on the authority of the Bankruptcy Court to make a final ruling on the plan confirmation issues at issue in the case. 805 F.3d at 432-433.[2]

c. The Court then set out the relevant factors to be considered (*id.* at 433-434) and concluded that, "Taken together, these factors require that the equitable mootness doctrine be applied only to "prevent[] a court from unscrambling complex bankruptcy reorganizations when the appealing party should have acted before the plan became extremely difficult to retract. The party seeking dismissal bears the burden to demonstrate that, weighing the relevant factors, dismissal is warranted." (*Id.* at 434; citations and quotes omitted).

d. It set out a two-step analysis (quoting *Semcrude*): "In practice, equitable mootness proceeds in two analytical steps: (1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on the plan's confirmation." (*Id.* at 434-435; quotes omitted).

e. Again citing *Semcrude*, it concluded: "If the confirmed plan has been substantially consummated, a court should next determine whether granting relief will require undoing the plan opposed to modifying it in a manner that does not cause its collapse." (*Id.*; citations and quotes omitted).

f. Applying this analysis, the Court reversed. It highlighted the modest amounts involved, the small number (17) of unsecured creditors, the absence of complex transactions required (no

2. This issue is discussed more fully in the Delaware District Court's discussion in *In re: Millennium Lab Holdings II, LLC*, 2017 U.S. Dist. LEXIS 38585 (D. Del. Mar. 17, 2017) (remanding for full briefing and decision by the Bankruptcy Court).

financing, mergers, stock issuances, or operational changes). It found that the Debtor failed to meet its burden of demonstrating that the plan would be difficult to unravel (*id.* at 436). It found only minimal third-party reliance of the kind present in all cases (*id.* at 437). Finally, it held that public policy favored appellate review. (*Id.* at 437.)

4. Concurring Opinion

a. Urges reconsideration of the equitable mootness doctrine. Describes its origin as judge-made and without analog in the abstention cases: "But where there is no other forum and no later exercise of jurisdiction, as in the case of equitable mootness, relinquishing jurisdiction is not abstention; it's abdication. In short, there is no analogue for equitable mootness among the abstention doctrines." (*Id.* at 440).

b. Notes that Supreme Court support is unlikely, especially in view of its recent cases narrowing the scope of abstention and other prudential doctrines. *See, e.g.*, *Sprint Communications, Inc. v. Jacobs*, 134 S. Ct. 854 (2013) (refusal to extend *Younger* abstention); *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 134 S. Ct. 1377 (2014) (refusal to limit cause of action created by statute as imprudent). (*Id.* at 440-441.)

c. Then (*id.* at 441-444) engages in an extended statutory analysis (beyond the scope of this outline) to show that the Bankruptcy Code and related jurisdictional statutes "provide no support for equitable mootness and actually undermine it." (*Id.* at 441.)

d. Rejects equitable mootness on Constitutional grounds under Article III § 1 (also beyond the scope of this outline). (*Id.* at 444-446.)

e. Finally, doubts efficacy of the doctrine, concluding that it just shifts the focus of the litigation from the merits of the confirmation objections to questions of plan consummation and the complexities of unwinding the plan. (*Id.* at 446-448)

D. *In re Transwest Resort Props., Inc.,* 801 F.3d 1161 (9th Cir. 2015)

1. Facts

Transwest filed a Chapter 11 petition in 2010 after defaulting on a $209 million mortgage loan and $21.5 million in mezzanine financing used to acquire resort hotels in South Carolina and Arizona. JPMCC 2007-C1 Grasslawn Lodging, LLC ("JPMCC") acquired the mortgage loan and the mezzanine loan, and filed proofs of claim totaling $299 million and $39 million, respectively. The hotels were valued at $92 million. Transwest proposed a plan of reorganization that would restructure the mortgage loan to require interest-only payments for 21 years, followed by a balloon payment, but with a ten-year exception that allowed the hotels to be sold at any time from five to 15 years after the effective date of the plan without triggering the obligation to pay back the loan. The plan also provided for the reorganized debtors to be acquired by Southwest Value Partners Fund ("SWVP"). In addition, the plan provided for no distributions with respect to the mezzanine loan unless the entity from whom JPMCC acquired the mezzanine loan voted in favor of the plan. JPMCC voted to reject the plan and objected to confirmation. It claimed its interest was impaired because of the ten-year exception in the plan, which would prevent JPMCC's claim from being satisfied by any sale proceeds during that time.

2. <u>Procedural Posture</u>

The Bankruptcy Court overruled JPMCC's objections, and entered an order confirming the plan. JPMCC filed timely motions with both the Bankruptcy Court and the District Court seeking to stay the confirmation pending appeal. Both courts denied these motions. The District Court then dismissed the appeal as equitably moot, finding that the plan was substantially consummated and that third parties had relied on the confirmation order. JPMCC appealed to the Ninth Circuit.

3. <u>Issue</u>

Was JPMCC's appeal arguing that it was an impaired creditor due to the due-on-sale clause in the plan equitably moot?

4. <u>Ruling</u>

The appeal was not equitably moot.

5. <u>Reasoning</u>

The Court of Appeals applied a four-part test from *Thorpe Insulation*. The *Thorpe Insulation* test weighs the appellant's diligent motion for a stay of the confirmation order, the substantial consummation of the plan, any effect on third parties not before the court, and whether the Bankruptcy Court can provide effective relief without irreparably disrupting the plan. Unlike the Second Circuit's rulings in *Chateaugay* and *Charter Communications*, the Ninth Circuit heavily weighed JPMCC's diligent action in moving to stay and seeking appeal as cutting "strongly in favor of appellate review," despite the fact that the plan was substantially consummated. The court found that the only parties that could be affected by any reallocation of sale proceeds would be JPMCC, reorganized Transwest, and SWVP. Additionally, granting partial relief to JPMCC would not cause the plan to unravel.

6. Dissent

The dissent argued that permitting the relief requested by JPMCC here would serve to discourage investment in companies that have begun restructuring proceedings. By doing so, it decreases the value of the bankruptcy estates. Further, granting relief because it is partial in nature can mean a court could always attach itself to some notional remedy and therefore never find an appeal to be equitably moot.

E. *Samson Energy Resources Co. v. Semcrude, L.P. (In re Semcrude, L.P.)*, 728 F.3d 314 (3d Cir. 2013)

1. Facts.

Some Oklahoma producers sold oil and gas on credit to the debtor before bankruptcy and contended they held statutory liens and property interests in what they sold. 728 F.3d at 318. The Bankruptcy Court established resolution procedures under which there would be one representative proceeding for each estate, and all interested parties were allowed to brief and participate in oral argument on their claims. 728 F.3d at 319. The Oklahoma producers unsuccessfully requested reconsideration from the Bankruptcy Court and the District Court denied them permission to appeal the procedures. 728 F.3d at 319. The producers commenced an adversary proceeding to assert their claims and to seek class certification to assert claims of similarly situated producers in Oklahoma. 728 F.3d at 319. The Bankruptcy Court stayed the adversary proceeding and granted summary judgment to the debtor in the representative Oklahoma, Kansas, and Texas proceedings, and certified them for direct appeal to the United States Court of Appeals for the Third Circuit. 728 F.3d at 319.

Then, the debtor and a statutory producers' committee reached a settlement that purported to resolve claims of all producers. 728 F.3d at 319. The debtor would pay $160 million in exchange for requiring that all adversary proceedings and other related litigation be voluntarily dismissed, and each of the producer classes accepted the plan. 728 F.3d at 319. Two of the four Oklahoma producers who started their own adversary proceeding accepted the plan and two abstained, but all of them objected to the plan, contending they should be allowed to continue their adversary proceeding.

The Bankruptcy Court confirmed the plan and it went effective in the absence of a request for a stay by the Oklahoma producers. 728 F.3d at 320. Certain claims were paid, and shares were issued under the plan. 728 F.3d at 320. The debtor moved to dismiss the producers' appeal as equitably moot, claiming that granting their requested relief would require unraveling the plan and would harm numerous third parties. 728 F.3d at 320. Appellants were not asking to set aside the class settlement for all Oklahoma producers. 728 F.3d at 323. They only wanted their claims allowed which would cost an incremental $207,300.62, or 0.13% of the $160 million settlement in the context of a $2 billion plan and a reorganized debtor having $140 million of working capital. 728 F.3d at 324. The debtor claimed a reversal could cost $81.7 million because the producers were seeking to bring a class action, but the appellate court declined to accept that consequence because, among other things, many producers in the class may have consented to the settlement. 728 F.3d at 324. M Additionally, it was not clear that the new lenders would want to or have the right to terminate their new loans if the appeal were successful. 728 F.3d at 325.

2. <u>Issues</u>

What is the standard to determine the applicability of equitable mootness and who has the burden of proof?

3. <u>Holdings</u>

"In practice, it is useful to think of equitable mootness as proceeding in two analytical steps: (1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation." "If this threshold is satisfied, a court should continue to the next step in the analysis. It should look to whether granting relief will require undoing the plan as opposed to modifying it in a manner that does not cause its collapse. It should also consider the extent that a successful appeal, by altering the plan or otherwise, will harm third parties who have acted reasonably in reliance on the finality of plan confirmation." 728 F.3d at 321.

"Dismissing an appeal over which we have jurisdiction, as noted, should be the rare exception and not the rule. It should also be based on an evidentiary record, and not speculation. To encourage this, we join other Courts of Appeals in placing the burden on the party seeking dismissal." 728. F.3d at 321.

4. Rationale

Though appellants would have been wise to seek a stay, their statutory right to appeal is not premised on their doing so. 728 F.3d at 323. The evidence neither showed the plan would unravel nor third parties would suffer harm if the appeal were sustained. 728 F.3d at 324.

"The presumptive position remains that federal courts should hear and decide on the merits cases properly before them. When equitable mootness is used as a sword rather than a shield, this presumption is upended." "Denying them review now – based on speculation of future harms – would be distinctly inequitable, the antithesis of the equity required for 'mootness.'" 728 F.3d at 326.

5. Analysis

The facts of *Semcrude* show how equitable mootness is used as a sword by plan proponents attempting to avoid review of confirmation orders. The Third Circuit dialed this back. *Semcrude* also presents a recurring theme about 'class settlements' not agreed to by all members of the class. The debtor put all putative lienholders in one class, notwithstanding that they had different collateral. 728 F.3d at 319. Implicit in the plan was that if any statutory lienholder had a valid secured claim, it would not be paid in full. It may well turn out that the statutory liens are not allowable, but the use of classification and class voting to prevent a claimant from establishing the allowability of its secured claim not only violates the classification rule that each secured claim having different collateral must be in a different class, but also raises constitutional issues under the Fifth Amendment.

Semcrude has company in the Fifth Circuit, which states it "has taken a narrow view of equitable mootness, particularly where pleaded against a secured creditor." *Wells Fargo Bank v. Texas Grand Prairie Hotel Realty, L.L.C. (In re Texas Grand Prairie Hotel Realty, L.L.C.)*, 710 F.3d 324, 328 (5th Cir. 2013); *In re Pacific Lumber Co.*, 584 F.3d 229, 243 (5th Cir. 2009)("Secured credit represents property rights that ultimately find a minimum level of protection in the takings and due process clauses of the Constitution. Federal courts should proceed with caution before declining appellate review of the adjudication of these rights under a judge-created abstention doctrine.").

F. *Motor Vehicle Cas. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.),* 671 F.3d 980 (9th Cir. 2012), amended by 677 F.3d 869 (9th Cir. 2012)

1. Facts

The Bankruptcy Court confirmed a chapter 11 plan in an asbestos case, over the objections of insurers whose policies would be used by the asbestos trust to satisfy claims. The insurers had been denied a full hearing on their objections on the ground the plan was insurance neutral and therefore the insurers lacked standing. After the District Court affirmed the confirmation order, the insurers were unsuccessful at procuring an emergency stay pending appeal, but the court of appeals expedited briefing, and the reorganized debtor started implementing the confirmed plan and moved to dismiss the appeal for mootness.

$135 million of $600 million had been transferred to the asbestos trust. [Of that, only $44.7 million had been spent, of which only $15 million went to claimants.] The facts in brackets were deleted from the opinion. 677 F.3d 869. This did not amount to substantially all property to be transferred under the plan and did not constitute substantial consummation. 671 F.3d at 92. The Bankruptcy Court could fashion remedies that would not hurt asbestos claimants, such as directing the debtors to transfer more money to the trust. 671 F.3d at 993. The Bankruptcy Court would be able to fashion equitable remedies. *Id*.

2. Issue

Was the appeal from the confirmation order moot or equitably moot?

3. Holding

No. "The plan has thus far proceeded to a point where it may not be viable totally to upset the plan, to tip over the § 524(g) apple cart. Yet, that does not mean that there could not be plan modifications adequate to give remedy for any prior wrong." 671 F.3d at 993. The plan could be modified to compel appellees to return money, to change the trust governance if it is biased, to make the trust distribution procedures nonbinding on direct suits against the appealing insurers, and to change the trust distribution procedures. *Id*. at 993-994. "If abandonment of the § 524(g) plan were the only possible remedy, then there might be equitable mootness." 671 F.3d at 994.

4. Rationale

Failure to obtain a stay is not fatal. If the passage of time prevents appeal, the doctrine would be "*inequitable* mootness." 671 F.3d at 992. Substantial consummation had not occurred. *Id*. Modification would not unduly bear on the innocent. 671 F.3d at 992. The Bankruptcy Court can fashion equitable remedies. 671 F.3d at 993- 994.

G. *Schroeder v. New Century Liquidating Trust (In re New Century TRS Holdings, Inc.),* 407 B.R. 576 (D. Del. 2009)

1. Facts

In July 2008, the Bankruptcy Court confirmed a liquidating chapter 11 plan for New Century TRS Holdings, Inc. over objections. The company had formerly originated, serviced, and purchased mortgage loans with 7,200 employees and $17.4 billion of credit facilities.

The confirmed plan grouped 16 debtors into 3 groups and aggregated the assets of each group for distribution to its aggregate creditors after payment of the group's aggregate administrative, priority, and secured claims. Certain protocols adjusted the distributions to general creditors so that, for instance, creditors having claims for which two debtors in a group were jointly and/or severally liable would receive 130% of their claims against one debtor and 0% of their claims from the other.

Certain employees of the debtors were beneficiaries of a trust to which they had contributed funds under deferred compensation plans. They sued for a determination that their money was not part of the debtors' estates (i.e., that the deferred compensation plans were not unfunded "top hat" plans under ERISA, 29 U.S.C. § 1051(2)).

The employees' class rejected the plan and objected to confirmation on the grounds that (a) it was an illegal substantive consolidation and (b) the protocol caused creditors in the same class to be treated differently in violation of Bankruptcy Code section 1123(a)(4). The Bankruptcy Court confirmed the plan and denied the objectors a stay pending appeal, but required the liquidating trust created under the plan to provide appellants 30 days' written notice of its intent to distribute any funds to certain classes.

The plan's effective date occurred. The creditors' committee dissolved. A plan advisory committee was formed. The debtors' officers and directors were replaced. The estates' assets were distributed to the liquidating trust. All the debtors' outstanding notes and stock were cancelled. 127,000 entities received notice of the effective date of the plans. The liquidating trust entered into contracts with a temporary legal staffing agency and an information technology contractor, extended a short term lease, and spent $1.3 million on those contracts. The trust spent $142,720 on a premium for a one-year bond covering its assets and $311,400 on a premium for a 3 year errors and omissions policy for the trust. The liquidating trust also spent $5.65 million on post-effective date professional fees. Certain claims were settled and allowed. In one settlement the trust paid $1.84 million, and paid lesser amounts to settle administrative claims. The trust also paid $2.6 million to employees to settle WARN Act claims and other claims arising from their termination.

2. Issue

Should the appeal be dismissed for equitable mootness?

3. Holding

No.

4. Rationale

An appeal should be dismissed as equitably moot if affording appellants relief "would be inequitable." 407 B.R. at 586-587 (quoting *In re PW Holding Corp.*, 228 F.3d 224, 236 (3d Cir. 2000)).

"It is reasonable to question whether the equitable mootness doctrine, as articulated by the Third Circuit, even applies in the liquidation context," although "the court is not aware of any reason why it should be concerned with inequitable appellate relief in a reorganization context but not in a liquidation context." 407 B.R. at 588 n. 27 (citing *In re Continental Airlines*, 93 F.3d 553, 560 (3d Cir. 1996); *Nordhoff Investments, Inc. v. Zenith Electronics Corp.*, 258 F.3d 180, 185 (3d Cir. 2001)).

"Thus, in a reorganization context, it makes sense to treat the unraveling of the plan as a significant fact weighing in favor of finding the appeal equitably moot. *See* generally *id*. However, it makes less sense to treat the unraveling of the plan with such significance in a liquidation context, since (in that context) the plan transactions tend to be discrete and relatively simple transactions aimed at disposing of the debtor's assets in the short term (sale or disposal of assets, services contracts to sustain the debtor through liquidation, etc.) and the non-adverse third parties transacting with the debtor are not doing so with any particular interest in debtor's future condition, let alone relying on debtor's future condition as contemplated by the particulars of any chapter 11 plan." 407 B.R. at 588.

"Two countervailing considerations inform the court's exercise of discretion. On the one hand, public policy is served by encouraging non-adverse third parties to rely on the finality of bankruptcy confirmation orders. *Continental*, 91 F.3d at 565. Since applying the doctrine brings finality, this suggests that there should be a low bar for applying the doctrine and that the court should construe facts accordingly. On the other hand, however, even while encouraging reliance on finality, the court must preserve a meaningful right of appeal. If the equitable mootness bar is too low, that is if equitable mootness factors swing too easily in favor equitable mootness, the right of appeal becomes meaningless and the instruction to apply the doctrine 'cautiously' and on a 'limited' scope, *PWS Holding*, 228 F.3d at 236, is contravened." 407 B.R. at 588.

While no stay was obtained, no creditor class has received distributions. The plan components that went forward were not components on which non-adverse third parties detrimentally relied. 407 B.R. at 589.

"Where parties have not relied to their detriment on finality, which is often the case in the liquidation context, this factor does not weigh in favor of equitable mootness." 407 B.R. at 590.

The plan effected an unwarranted substantive consolidation and treated claims in the same class differently without consent in violation of Bankruptcy Code section 1123(a)(4). 407 B.R. at 592.

Extraterritorial Application of Avoidance Powers

By Philip Bentley and G. David Dean[1]

In recent years, a number of courts – mostly in the Southern District of New York – have grappled with whether the Bankruptcy Code's avoidance provisions can be utilized to avoid and recover transfers that are extraterritorial in nature, as well as the related issue of what makes a transfer either domestic or extraterritorial for this purpose. A recent decision by the Second Circuit Court of Appeals, *In re Picard*, 917 F.3d 85 (2d Cir. Feb. 25, 2019) ("***Picard***"), holding that the trustee liquidating Bernard Madoff's investment firm can recover billions of dollars of Ponzi scheme proceeds from foreign investors who received the proceeds indirectly through foreign "feeder funds," clarifies the latter issue, though not the former.

In this outline, we provide a brief summary of (i) the general principles governing the extraterritorial application of federal law and (ii) the prior case law applying these principles to avoidance claims under the Bankruptcy Code. We then discuss the Second Circuit's *Picard* decision and its implications.[2]

I. Background: The Law of Extraterritoriality

a. The Supreme Court has long recognized a presumption against the extraterritorial application of U.S. laws.

   i. "It is a long-settled principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States." *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2877 (2010) (quotation omitted); *see also WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129 (2018); *RJR Nabisco, Inc. v. European Community*, 136 S. Ct. 2090 (2016).

   ii. This principle "represents a canon of construction, or a presumption about a statute's meaning, rather than a limit upon Congress's power to legislate." It "rests on the perception that Congress ordinarily legislates with respect to domestic, not foreign, matters." *Morrison*, 130 S. Ct. at 2877.

b. These Supreme Court cases establish a two-step framework for analyzing extraterritoriality issues.

   i. Has the presumption against extraterritoriality been rebutted?

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[2] A related issue – the circumstances in which principles of international comity bar application of the Code's avoidance provisions – is outside the scope of this outline.

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1. Does the statute give a clear affirmative indication that it applies extraterritorially? If the answer is yes, the inquiry is over, and the statute can be applied extraterritorially. If the answer is no, the court must address the second step.

ii. Does the case involve a domestic or a foreign application of the statute?

1. This is determined by ascertaining the statute's "focus." If the conduct *relevant to the statute's focus* occurred in the U.S., then the case involves a permissible domestic application even if other conduct occurred abroad. If the conduct relevant to the focus occurred in a foreign country, then the case involves an impermissible extraterritorial application.

2. As the Supreme Court explained in *WesternGeco*, the focus of a statute is "the object of its solicitude, which can include the conduct it seeks to 'regulate,' as well as the parties and interests it seeks to 'protect' " or vindicate." 138 S. Ct. at 2137. "If the statutory provision at issue works in tandem with other provisions, it must be assessed in concert with those other provisions." *Id.*

c. A related issue is whether application of U.S. law would contravene principles of international comity. This topic is complex and fact-specific, and we do not address it in this outline other than to note that it subsumes two interrelated doctrines: (i) prescriptive comity, which applies when "Congress, out of respect for foreign sovereigns, limited the application of domestic law on a given set of facts," *Picard*, 917 F.3d at 100; and (ii) adjudicative comity, involving the court's discretionary decision to "abstain from exercising jurisdiction in deference to a foreign nation's courts that might be a more appropriate forum for adjudicating the matter," *id.* at 100-01.

II. <u>Case Law Prior to *Picard* Addressing the Extraterritorial Application of the Bankruptcy Code's Avoidance Provisions</u>

The courts are divided as to whether Congress intended the Bankruptcy Code's avoidance powers to have extraterritorial application. This case law split survives the Second Circuit's *Picard* decision, which does not address this issue. On the second extraterritoriality issue – whether a particular transfer is domestic or foreign – most courts prior to *Picard* applied a "center of gravity" approach of the sort often used for choice of law determinations.

a. *Maxwell Com'n Corp. PLC v. SocGen PLC* (*In re Maxwell Com'n Corp.*), 186 B.R. 807 (S.D.N.Y. 1995) ("***Maxwell***") (Scheindlin, J.), *aff'd,* 93 F.3d 1036 (2d Cir. 1996)

i. <u>Facts</u> – The debtor was an English company that incurred most of its debts in England but had most of its assets in the U.S. Upon filing for chapter 11 relief, the debtor sought to avoid and recover preferential transfers it had made to various banks, including French bank Societe Generale, pursuant to 11 U.S.C. §§ 547(b) and 550.

ii. Holding – These transfers were foreign, and Congress did not intend § 547 to apply extraterritorially. In addition, the claims were barred by comity considerations.

iii. Reasoning

1. The debtor argued that the transfers were domestic, and that extraterritorial application of U.S. law therefore was not required, principally because the debtor had obtained the monies it paid the banks from the sale of U.S. assets. The district court disagreed, ruling that the transfers occurred overseas because (i) the debtor and its transferees were foreign entities, (ii) the transfers were made from English banks, and (iii) the antecedent debt had been incurred overseas. 186 B.R. at 817.

2. The court next examined the language and legislative history of § 547 and concluded that Congress did not intend to apply this provision extraterritorially. The court rejected the argument that § 541(a)(3) evidenced such intent: "§ 541 by its terms only applies to property which is property of the estate. Because preferential transfers do not become property of the estate until recovered, § 541 does not indicate [that] Congress intended § 547 to govern extraterritorial transfers." *Id.* at 820 (citation omitted).

iv. Second Circuit affirmance – The Second Circuit affirmed the district court's comity ruling, without addressing that court's extraterritoriality holding. The Circuit held that application of the Code's preference provisions would contravene international comity principles, particularly given the parallel insolvency case that was proceeding in English court and in which English preference laws applied.

b. *French v. Liebmann* (*In re French*), 440 F.3d 145 (4th Cir. 2006) – the only court of appeals decision other than *Picard* that has addressed extraterritoriality

i. Facts – Debtor, a Maryland resident, gifted Bahamian real property to her children. The chapter 7 trustee sought to avoid this transfer pursuant to 11 U.S.C. § 548(a)(1)(B) and to recover the property or its fair market value. The transferees sought to dismiss the avoidance action on two grounds: (1) under the presumption of extraterritoriality, section 548 should not apply to transfers of foreign property; and (2) international comity favored application of Bahamian bankruptcy law, under which they would retain the property.

ii. Holding – Congress made manifest its intent that 11 U.S.C. § 548 applies to all property that, absent a prepetition transfer, would have been property of the estate, wherever that property is located.

iii. Reasoning

1. The Fourth Circuit declined to determine whether the transfer was foreign or domestic, given its ruling that extraterritorial application of section 548 is permissible. 440 F.3d at 150-51.

2. The court's analysis of Congressional intent focused on 11 U.S.C. §§ 541 and 548. Section 541 provides that all of the debtor's property – foreign as well as domestic – is property of the debtor's estate. Section 548, in turn, provides for avoidance of certain transfers of such "interests of the debtor in property." The court found that, by this language, § 548 allows a trustee to avoid any transfer of property that would have been property of the estate prior to the transfer in question. Through this incorporation, Congress made clear its intent that § 548 apply to all property that, absent a prepetition transfer, would have been property of the estate, wherever located. *Id.* at 151–52.

3. The court also found that principles of international comity favored applying U.S. law. The property at issue is part of the debtor's estate, and the U.S. has a stronger interest than the Bahamas in regulating the transaction, particularly since the majority of the interested parties are in the U.S. *Id.* at 154.

c. *SIPC v. Bernard L. Madoff Inv. Secs. LLC* (*In re Bernard L. Madoff*), 480 B.R. 501 (Bankr. S.D.N.Y. 2012) (Lifland, J.) – a case not often cited, but with reasoning on the domestic-vs.-foreign issue strikingly similar to that of the Second Circuit in *Picard*

i. Facts – BLI, a Taiwanese entity, invested in Fairfield Sentry, a feeder fund organized in the British Virgin Islands that invested substantially all of its assets in Bernard L. Madoff Investment Securities ("BLMIS"). BLMIS transferred monies to Fairfield Sentry, which in turn transferred the monies to BLI. The BLMIS trustee sought to recover the subsequent transfer made by Fairfield Sentry to BLI pursuant to 11 U.S.C. § 550.

ii. Holding – The initial transfers of the debtor's assets occurred in the U.S. Consequently, those transfers *and* Fairfield Sentry's subsequent transfers to its own (foreign) investors are domestic and do not involve the extraterritorial application of 11 U.S.C. § 550.

iii. Reasoning

1. The court found that "the focus of the avoidance and recovery sections is on the *initial transfers* that deplete the bankruptcy estate and not on the recipient of the transfers or the subsequent transfer." 480 B.R. at 524. Here, the transfers at issue originated from BLMIS' New York account and went to Fairfield Sentry's New York account. These domestic acts are the "objects of the statute's solicitude" and what the statute "seeks to regulate." *Id.* at 525. Since the focus of section 550 occurred domestically, "the fact that BLI received BLMIS's fraudulently transferred property in a foreign country does not make the Trustee's application of this section extraterritorial." *Id.*

2. The court found that, even if the trustee was seeking to apply the section extraterritorially, Congress expressed a clear intent to permit such application. Congress' intent that section 550(a) apply extraterritorially is evident through "interweaving terminology and cross-references to relevant Code provisions" including (i) "property of the estate" under section 541, which includes property worldwide, (ii) the avoidance provisions of sections 544, 547, and 548, which incorporate language of section 541, and (iii) section 550, which explicitly authorizes recovery of all transfers that have been avoided, necessarily inclu ding overseas property. 480 B.R. at 527.

d. *Weisfelner v. Blavatnik* (*In re Lyondell*), 543 B.R. 127 (Bankr. S.D.N.Y. 2016) (Gerber, J.) ("***Lyondell***")

i. Facts – Basell, a Luxembourg entity, acquired Lyondell, a Delaware corporation, in an LBO and merger. Two weeks before the merger, Basell distributed $100 million to its own shareholders, which included defendant BI S.a.r.l., a Luxembourg entity. Lyondell filed for chapter 11 bankruptcy approximately one year later. The litigation trustee sought to avoid and recover the shareholder distribution as a fraudulent transfer under 11 U.S.C. §§ 548 and 550. Defendant BI S.a.r.l. moved to dismiss the fraudulent transfer claim, arguing that the transfer was extraterritorial because it was made by one foreign entity (Basell) to another foreign entity (BI S.a.r.l.).

ii. Holding – The transfer was extraterritorial, but Congress intended 11 U.S.C. § 548 to cover extraterritorial conduct and therefore the transfer could be recovered.

iii. Reasoning

1. The transfer was extraterritorial. The court stated that courts use a "flexible" approach, applying a "center of gravity" test under which they look at the facts of a case to determine whether the

center of gravity is outside the United States. Even though the transfer here was from one foreign entity to another, certain "component" elements showed a connection to the U.S.: (i) at least some of the decisions to make the transfer occurred in the U.S.; (ii) the merger had substantial connections to the U.S., and the transfer was part of the merger; and (iii) the transfer rendered Basell, and thus the company resulting from the merger, undercapitalized.

2. The court found the transfer was foreign as it was made from one foreign entity to another. The court noted that the trustee did not provide any evidence that funds ever passed through the U.S.

3. The court held that Congress intended section 548 to apply extraterritorially. A "bankruptcy court has *in rem* jurisdiction over all of a debtor's property, whether foreign or domestic." 543 B.R. at 151 (citing 28 U.S.C. § 1334; 11 U.S.C. § 541). In addition, section 550 authorizes a trustee to recover transferred property for the benefit of the estate to the extent the transfer is avoided under either section 544 or 548. The court found the Fourth Circuit's decision in *French* persuasive, and agreed with Professor Jay Westbrook's conclusion that section 541(a)(3) supports a finding that section 548 applies extraterritorially. 543 B.R. at 154.

e. *Spizz v. Goldfarb Seligman & Co.* (*In re Ampal-American Israel Corp.*), 562 B.R. 601 (Bankr. S.D.N.Y. 2017) (Bernstein, J.) ("***Ampal-American*"*)*

i. Facts – The debtor was a New York corporation headquartered in Israel, which served as a holding company owning interests in subsidiaries primarily located in Israel. The debtor retained an Israeli law firm – the defendant – to provide legal services to the debtor in connection with various matters in Israel. The debtor instructed an Israeli bank to transfer $90,000 from its account to the defendant's account with the same bank. The chapter 7 trustee filed an adversary proceeding to avoid and recover the prepetition transfer made in Israel to the Israeli law firm as a preference pursuant to 11 U.S.C. §§ 547 and 550.

ii. Holding – Congress did not intend avoidance provisions to apply extraterritorially. Since the transfer occurred in Israel, the court dismissed the action.

iii. Reasoning

1. "Property transferred to a third party prior to bankruptcy in payment of an antecedent debt is neither property of the estate nor property of the debtor *at the time the bankruptcy case is commenced*, which are the only two categories of property mentioned in § 541(a)(1)." 562 B.R. at 612.

2. While some provisions of the Bankruptcy Code contain clear statements that they apply extraterritorially, section § 547(b) does not. *Id.*

3. The court found that the transfer was not domestic. It occurred in Israel between a U.S. transferor headquartered in Israel and an Israeli transferee, and it was accomplished between accounts in the same Tel Aviv bank. Since the transfer was not domestic, it could not be avoided. *Id.* at 613–14.

f. *In re FAH Liquidating Corp.*, 572 B.R. 117 (Bankr. D. Del. 2017) (Gross, J.) ("***FAH Liquidating***")

i. <u>Facts</u> – The U.S. debtor was a party to supply agreements with BMW, a German corporation. The agreements were governed by German law and included a German forum selection clause. The liquidating trustee sued the German corporation to avoid $33 million in wire transfers that were made pursuant to the supply agreements, under 11 U.S.C. §§ 542, 544, 548(a)(1)(B), and 550.

ii. <u>Holding</u> – The transfers were extraterritorial, but the presumption against extraterritoriality did not prohibit the use of section 548 because Congress intended that provision to apply extraterritorially.

iii. <u>Reasoning</u>

1. To determine whether the transfers were extraterritorial, the court applied the "center of gravity" test, concluding that the center of gravity for the transfers at issue was Germany. While the transfers originated in the U.S. from a U.S. corporation, the agreements were primarily of a foreign nature, as evidenced by the forum selection clause, applicable law being German, and payment being required in euros. 572 B.R. at 124.

2. Adopting the reasoning of *French* and *Lyondell*, the court found that Congress intended section 548 to apply extraterritorially: "By incorporating the language of [section] 541 to define what property a trustee may recover under his avoidance powers, [section] 548 plainly allows a trustee to avoid any transfer of property that would have been 'property of the estate' prior to the transfer in question as defined by [section] 541 even if that property is not 'property of the estate.'" *Id.* at 125 (quoting *French*).

g. *Comm. of Unsecured Creditors of Arcapita Bank B.S.C.(c) v. Bahrain Islamic Bank* (*In re Arcapita Bank B.S.C. (c)*), 575 B.R. 229 (Bankr. S.D.N.Y. 2017) **("*Arcapita*")**.

i. Facts – The creditors' committee filed an adversary proceeding to avoid and recover preferential transfers by a foreign debtor (a Bahraini investment bank) to another foreign entity pursuant to Sections 547 and 550 of the Bankruptcy Code. The transfers at issue occurred using a U.S. bank account.

ii. Holding – Among other things, the court rejected the defendants' extraterritoriality defense.

iii. Reasoning

1. The parties did not appear to dispute that the statute must relate to a domestic application to be used.

2. The court therefore turned to whether the challenged transfer involved a domestic application of the statute. The court found that it did, focusing on the U.S. bank account and finding support for the proposition that the use of a U.S. bank account alone justified the result.

h. *In re CIL Ltd.*, 582 B.R. 46 (Bankr. S.D.N.Y. 2018) (Garrity, J.)

i. Facts

1. The debtor was a Cayman Islands holding company that owned 100% of the CEVA Group, a U.K. entity. In April 2013, the debtor participated in an out-of-court restructuring of CEVA Group, whereby new CEVA Group stock was issued to a newly formed Marshall Islands company, and the debtor was left with a 00.01% interest in CEVA Group. The debtor then filed a petition commencing liquidation proceedings in the Cayman Islands, and an involuntary chapter 7 petition was filed against the debtor in the United States.

2. The chapter 7 trustee filed an adversary proceeding seeking *inter alia* to avoid and recover the initial stock transfer made as part of the restructuring pursuant 11 U.S.C. §§ 544(b), 548(a)(1)(A), 550 and 551.

ii. Holding – The transfer to be avoided was foreign, and Congress did not intend for the avoidance provisions to be applied extraterritorially; it therefore cannot be avoided under 11 U.S.C. § 548.

iii. Reasoning

1. The transfer was not a domestic transfer: The issuance of the new shares took place outside of the U.S., the debtor consented to the restructuring through its board at a series of meetings in London,

and the new shares were issued in accordance with U.K. law. 582 B.R. at 93–94.

2. The court found that Congress did not express an affirmative intent to apply sections 548 and 550 extraterritorially. "Congress's failure to do so, particularly in light of the fact that sections 541(a)(1) and 1334(e) expressly apply extraterritorially, operates to limit sections 548 and 550 to their terms. Moreover, the Court agrees with *Maxwell* and *Madoff/CACEIS* that in assessing the scope of the Bankruptcy Code's avoidance provision section 541(a)(1) is irrelevant because property that is the subject of an action does not become estate property until it is recovered." *Id.* at 92.

III. The Second Circuit's *Picard* Decision

a. Facts – The Trustee for Madoff Investment Securities alleged that that firm (a domestic entity) had fraudulently transferred billions of dollars to foreign "feeder funds," which in turn had transferred these monies to their own investors, who were also foreign. The Trustee sought (i) to avoid the transfers to the feeder funds as intentional fraudulent transfers under 11 U.S.C. § 548(a)(1)(A) and (ii) to recover these monies from the subsequent transferees (the feeder fund s' investors) under 11 U.S.C. § 550(a)(2).

b. Holding

   i. The lower courts dismissed the Trustee's claims against the feeder funds' investors on the grounds that both the presumption against extraterritoriality and considerations of international comity barred the Trustee from using section 550(a)(2) to recover from those parties.

   ii. The Second Circuit reversed, holding that the debtor's transfers to the (foreign) feeder funds *and* those funds' subsequent transfers of the monies to their own (foreign) investors constituted domestic activity – not barred by the presumption against extraterritoriality – for the purposes of §§ 548(a)(1)(A) and 550(a)(2). The Circuit also held that principles of international comity did not bar the Trustee's claims.[3]

c. Reasoning

   i. The Second Circuit addressed only the second step of the Supreme Court's two-step framework: whether the transfers to the feeder funds' investors were domestic or foreign. Because the Circuit concluded these transfers were domestic, it did not address whether Congress intended to permit the extraterritorial application of the Bankruptcy Code's avoidance provisions.

[3] Appellees' petition for rehearing *en banc* was denied by the Second Circuit on April 3, 2019.

ii. Following the Supreme Court's guidance in *RJR Nabisco* and *WesternGeco*, the Second Circuit began its analysis of the domestic-vs.-foreign issue by considering the "focus" of Bankruptcy Code § 550(a)(2), which permits the recovery of fraudulent transfers from subsequent transferees. *Picard*, 917 F.3d at 96. In doing so, the court looked at not only section 550(a)(2) but also section 548(a)(1)(A), which authorizes the avoidance of intentional fraudulent transfers, since these two provisions work "in tandem." *Id*. at 97.

iii. The court held that the focus of these two provisions, taken together, is on the *debtor's* transfer (i.e., the initial transfer), rather than on subsequent transfers made by transferees:

"While § 550(a) authorizes recovery, 'what a statute authorizes is not necessarily its focus.' When § 550(a) operates in tandem with § 548(a)(1)(A), recovery of property is 'merely the means by which the statute achieves its end of' regulating and remedying the fraudulent transfer of property. . . . While the subsequent transfer may indirectly harm creditors by making property more difficult to recover, *it is the initial transfer that fraudulently depletes the estate. Only the initial transfer involves fraudulent conduct, or any conduct, by the debtor*." *Id*. at 98 (emphasis added; citations omitted).

iv. Consequently, the Court of Appeals held, it is the location of the debtor's transfers, not the subsequent transfers, that is dispositive. If the debtor's transfers occurred in the United States, then both the debtor's transfers *and* any subsequent transfers made by transferees are deemed domestic – even if those subsequent transfers occurred abroad, as they did here. In these circumstances, recovery from the subsequent transferees does not involve the extraterritorial application of U.S. law. *Id*.

v. Moreover, in determining the location of the debtor's transfers, the court found it dispositive that "(1) the debtor is a domestic entity, and (2) the alleged fraud occurred when the debtor transferred property from U.S. bank accounts." *Id*. at 99 n.9; *see also id*. at 100 ("The relevant conduct in these actions is the debtor's fraudulent *transfer* of property, not the transferee's *receipt* of property. When a domestic debtor commits fraud by transferring property from a U.S. bank account, the conduct that § 550(a) regulates takes place in the United States.") (emphasis in original).

vi. Because the Court of Appeals found that the case involved the domestic application of section 550(a), it did not address whether Congress intended that section to have extraterritorial application. *Id*.

vii. Finally, the Second Circuit reversed the lower courts' holding that the Trustee's claims against the feeder funds' investors were barred by considerations of international comity (prescriptive comity in particular):

> "We . . . hold that the United States' interest in applying its law to these disputes outweighs the interest of any foreign state. Prescriptive comity poses no bar to recovery when the trustee of a domestic debtor uses § 550(a) to recover property from a foreign subsequent transferee on the theory that the debtor's initial transfer of that property from within the United States is avoidable under § 548(a)(1)(A), even if the initial transferee is in liquidation in a foreign nation." *Id*. at 105.

IV. Observations

a. As noted, the Second Circuit in *Picard* did not address whether Congress intended the Bankruptcy Code's avoidance provisions to have extraterritorial application. Thus, the split in the case law on this issue remains unresolved. Parties seeking extraterritorial application of these provisions will continue to rely on cases such as *French* and *Lyondell*, holding that Congress intended sections 548 and 550 to apply to all property – foreign as well as domestic – that would have been property of the estate under section 541 absent the fraudulent or preferential transfer. Parties opposing extraterritorial application will continue to point to cases to the contrary, such as *Maxwell*, *Ampal-American* and *CIL.*

b. On the separate issue of whether a particular transfer is domestic or foreign, *Picard* clarified the law in several respects, which are controlling within the Second Circuit and should be persuasive in other circuits.

   i. Subsequent transfers:

      1. *Picard* holds that, at least in cases of intentional fraudulent transfer, the focus of the Bankruptcy Code's avoidance provisions – including section 550(a)(2) – is on the debtor's initial transfer. Consequently, if the debtor's initial transfer is domestic, the recovery of subsequent transfers made by that transferee must also be deemed domestic.

      2. The Second Circuit limited its holding to claims of intentional fraudulent transfer: "Section 550(a) may serve different purposes depending on which of the Bankruptcy Code's avoidance provisions enables recovery. We express no opinion on the focus of § 550(a) in actions involving any avoidance provision other than § 548(a)(1)(A)." *Id*. at 98 n. 7. Nevertheless, the stated logic of the court's ruling – that only the initial transfer (a) depletes the debtor's estate and (b) involves conduct by the debtor, *see id.* at 98 – would seem to apply no less to preference and constructive fraudulent transfer claims than to intentional fraudulent transfer claims.

   ii. Initial transfers:

1. In contrast to prior cases, which had adopted a multi-factor balancing test to determine whether a debtor's transfer was domestic or foreign, the Second Circuit focused on only two factors, holding that a transfer is domestic if (i) the debtor is a domestic entity and (ii) the allegedly fraudulent transfer was made from U.S. bank accounts.

2. This holding is contrary to at least one prior case: *FAH Liquidating*, a 2017 Delaware bankruptcy court case that found wire transfers to be foreign even though they were made by a U.S. debtor from a U.S. bank account.

3. *Picard* does not address whether a transfer would be deemed domestic or foreign if one but not the other of the two factors identified by the Second Circuit existed – that is, if the transfer were made by a U.S. debtor from a foreign bank account or, alternatively, by a foreign debtor from a U.S. bank account.

4. Prior cases in the Southern District of New York lend some support to the view that, when these two factors cut in opposite directions, the location of the bank account from which the transfer was made may be entitled to greater weight than whether the debtor is a domestic or a foreign entity. *Compare Arcapita* (transfer made from debtor's U.S. bank account was domestic even though debtor was a Bahrain bank) *with Ampal-American* (transfer made from debtor's Israeli bank account was foreign even though debtor was a U.S. holding company); *see also Lyondell* (transfer made by Luxembourg company was foreign, where there was no evidence that payment was made from the U.S.).

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The Use of Market Evidence in Valuation Disputes

Faten Sabry
Managing Director, Ph.D.

New York City Bankruptcy Conference
May 22, 2019

Insight in Economics™

Roadmap

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- Market measures of value
- Event study using CDS prices
- Assessing structural changes
- Implied default probability using market evidence

1

Delaware Court of Chancery Verition v. Aruba Networks, Inc.

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- "The Delaware Supreme Court's recent decisions in DFC and Dell teach that if a company's shares trade in a market having attributes consistent with the assumptions underlying a traditional version of the semi-strong form of the efficient capital markets hypothesis, then the unaffected trading price provides evidence of the fair value of a proportionate interest in the company as a going concern."

  – The Honorable J. Travis Laster, Vice Chancellor, *Verition Partners Master Fund Ltd., et al. v. Aruba Networks, Inc.* (Del. Ch. Feb. 15, 2018).

2

Case Study - Timeline for Retail Company X

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Oct 2001	Company X becomes the largest retailer in Midwest
Mar 2015	Financial disclosure with unexpected low earnings
Apr 2015	Company X announces it will receive a $500 MM loan package
May 2015	Company X avoids default by paying $500 MM in principal
Jun 2015	Company X files for Chapter 11 bankruptcy

3

Lawsuit – Creditors v. Company X

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- Key allegations:
  - Loan package was offered by CDS protection sellers that wanted the company not to default before their CDS expired on May 2015
  - Loan package deteriorated the financial position of the company and led to bankruptcy
- Company X position:
  - Low earnings and market landscape explain company's demise

4

Event Study Using CDS
Identify Relevant Comparables

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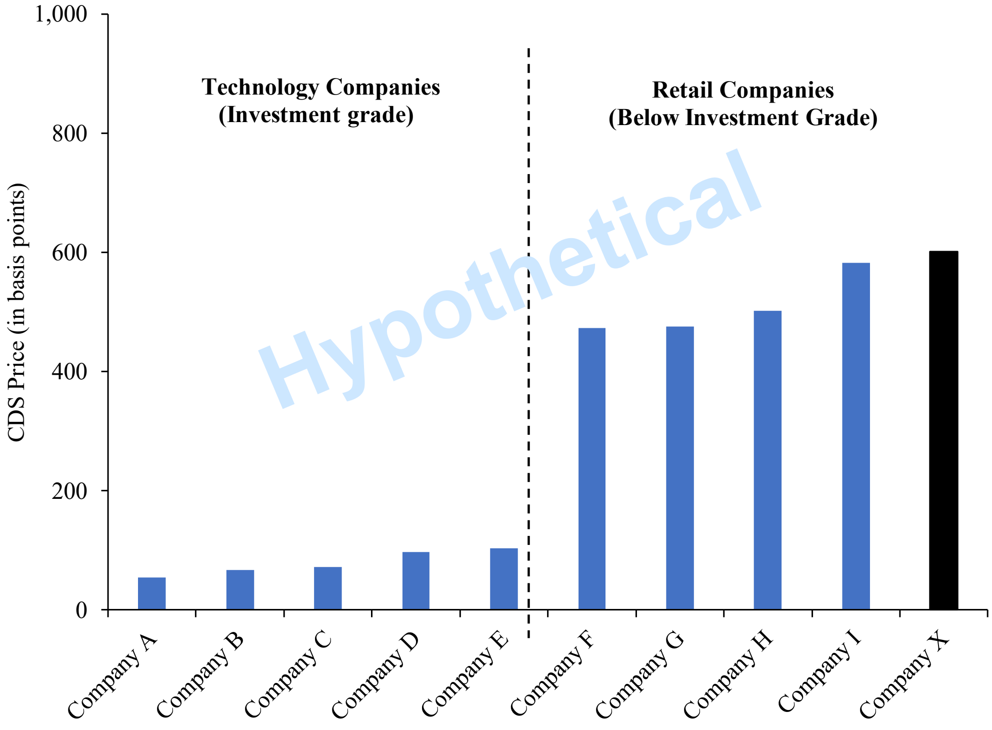

5

CDS Market Reaction to Announcements

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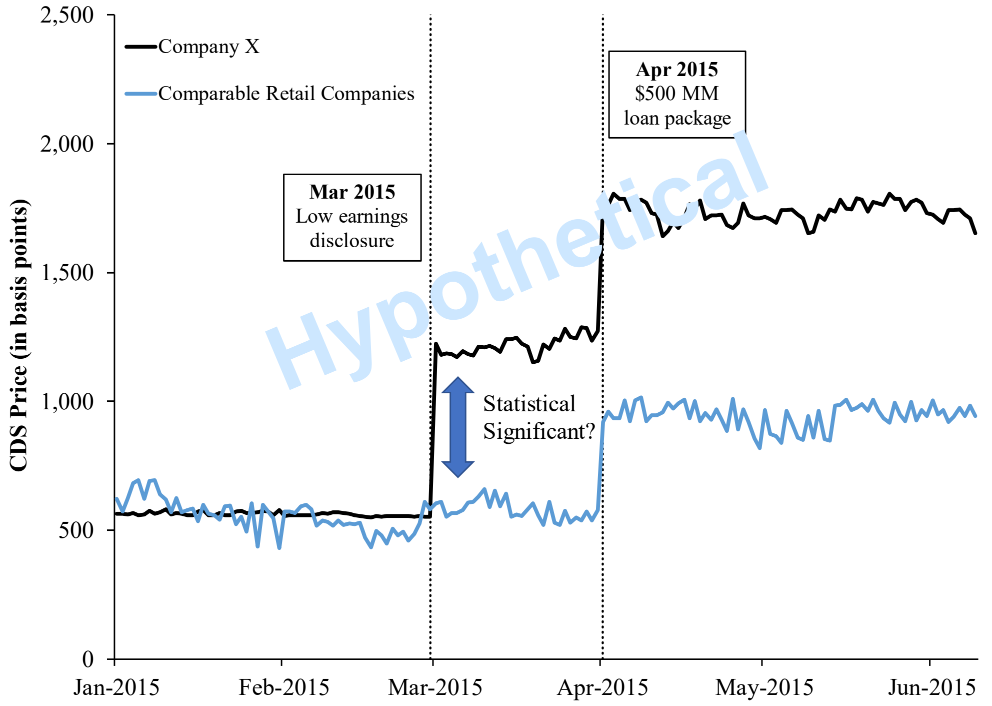

6

Timing of the Structural Changes

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	R Squared for CDS Price Differential between Company X and Comparable			
Date	**Company F**	**Company G**	**Company H**	**Company I**
February 27	0.60	0.53	0.45	0.65
February 28	0.63	0.55	0.46	0.66
Low earnings disclosure	**0.81**	**0.75**	**0.65**	**0.90**
March 2	0.63	0.61	0.33	0.55
March 3	0.62	0.59	0.32	0.53

7

Price of CDS and Risk of Default

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- CDS prices as measures of credit risk
- CDS of different tenors and default probability over different time horizons

8

Default Risk, Company and Market Factors

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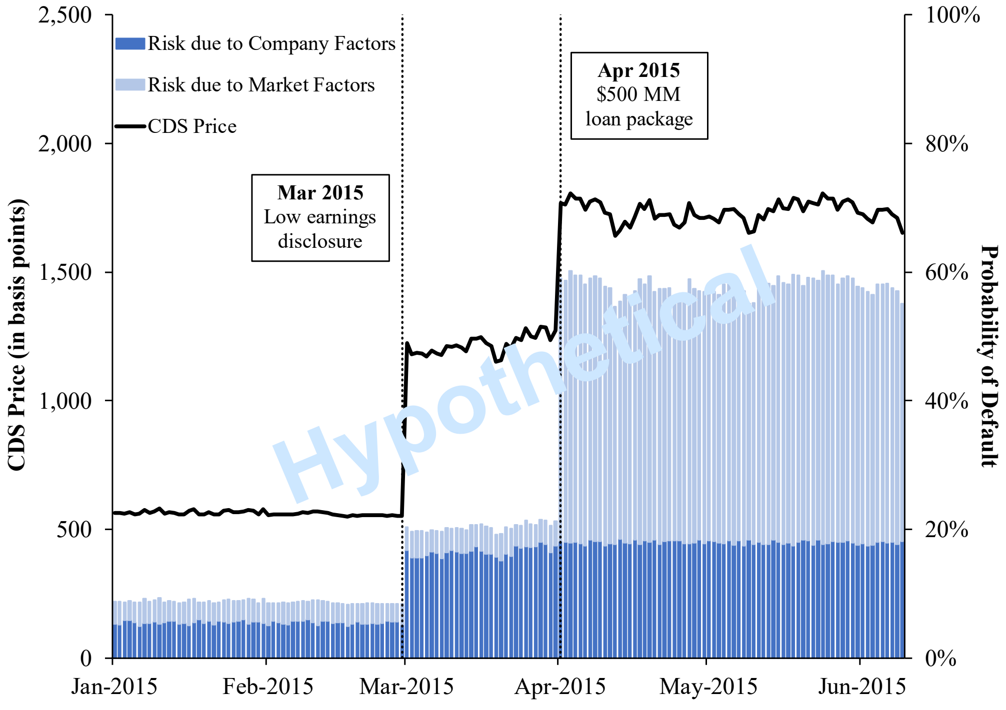

9

Litigation Over Use of CDS to Force or Prevent a Default

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- Radio Shack
- General Motors
- Codere
- Six Flags
- Caesars

10

Fraudulent Conveyance Update: In the Next Economic Downturn, Will Fraudulent Conveyance Challenges to the Recent LBO's, Spinoffs, and Dividends Have a Real Chance of Success?

By: James Donnell

Summary

It is well established that dividend recapitalizations, corporate spinoffs, leveraged buyouts, and similar sophisticated corporate transactions can be subsequently challenged as constructive fraudulent transfers if the subject company later enters bankruptcy. The transfers made for "less than equivalent value" in those transactions can be avoided if the company is later found to be insolvent at the time of the transaction. In prior years, such challenges were frequently successful. Courts would determine whether the subject company was insolvent or not based largely on competing valuations made by competing expert witnesses.

In the last few years however, rulings from the bankruptcy courts effectively erected two hurdles to proving insolvency, which lower the odds of actually prevailing in such challenges. Specifically, bankruptcy judges have ruled that: (i) the determination of whether the company was insolvent should be based in the first instance on any "reasonable" financial projections made by company management and solvency opinions made by the company's advisors at the time of the transaction, and (ii) if the company's stock traded actively in a market at a price that implied substantial equity value existed at the time of the transaction, such fact necessarily precludes a finding that the company's assets were worth less than its liabilities.

Several courts had also previously held that proceeds and securities distributed in such transactions were exempt from recovery as constructive fraudulent conveyances if they passed through a bank or other financial institution. The Supreme Court's recent decision in *Merrit* largely eliminates this hurdle and prevents a company from immunizing a transaction against fraudulent transfer challenge simply by washing the proceeds through a bank. Instead, only distributions to qualified entities under 11 U.S.C. § 546(e) are exempt from a constructive fraudulent conveyance challenge.

However, the other two hurdles remain and recent case law strongly suggests that most bankruptcy courts will be unwilling to make the requisite finding of insolvency in most properly papered, sophisticated transactions. Certainly, the financial advisors and attorneys documenting these sophisticated transactions can be expected to procure a solvency opinion and go through all of the procedures designed to demonstrate that the transaction was approved by supposedly independent directors and outside advisers. Assuming that they do comply with these steps, recent bankruptcy rulings suggest that, while a successful challenge is still theoretically possible, it is unlikely to succeed.

The odds of success appear to drop much further still in the event that there is an active market for the company's stock or debt securities and substantial equity value is indicated by the stock price.

Under such circumstances, counsel asserting the fraudulent conveyance must resort to trying to identify conflicts of interest or a failure of the company to disclose some major liability in order to convince the bankruptcy judge to accept his expert's insolvency report and discount the credibility of the company's original financial projections and solvency opinions. Such efforts may prove futile. And convincing the court to find insolvency in the face of an active market showing substantial stock value is even less likely to succeed, no matter how irrational the market's exuberance.

However, there is an alternative to trying to persuade a bankruptcy judge to make a finding of insolvency: seek a jury trial instead. While there is a split among the circuit courts on the issue, the Second Circuit, Third Circuit and Fifth Circuit have ruled that in many circumstances, a bankruptcy trustee or other party asserting a fraudulent conveyance on behalf of the bankruptcy estate retains any right it originally had to a jury trial. Especially where the defendant transferees have not filed proofs of claims in the bankruptcy, state law fraudulent conveyance claims should be entitled to jury trials.

Note that the bankruptcy court determinations of solvency based on favoring the contemporaneous management projections, solvency opinions, and stock price evidence over the plaintiff's competing financial valuations are ultimately findings of fact, not rulings of law. And this is confirmed by the existence of the *Tronox* decision (which found insolvency notwithstanding management's solvency opinions and a positive stock price) and the subsequent bankruptcy court opinions distinguishing *Tronox* on its facts, but not overruling or rejecting it. A jury may be more willing make findings of fact consistent with a challenger's valuation analysis, and to grant less deference to management projections and solvency opinions used to justify the challenged transaction. Likewise, a jury may be more open to the argument that a positive stock price is not necessarily dispositive evidence of solvency.

Can a fraudulent transfer challenge succeed against a properly papered transaction supported by management projections and a solvency opinion?

Fraudulent transfer challenges once again seem feasible, now that the Supreme Court has ruled in *Merrit* that proceeds and distributions from LBO's, spinoffs, and dividends cannot be made exempt from fraudulent conveyance attack merely by clearing the proceeds through a bank. Can bankruptcy trustees and creditor committees now confidently proceed with challenges to suspect corporate transactions? A recent article discussed below suggests that companies engaging in LBO's, spinoffs, and dividends are at risk of their actions being successfully challenged as fraudulent transfers.

With the exception of "intentional fraudulent conveyances", the ability to prove a fraudulent conveyance will hinge on being able to convince the bankruptcy judge that the subject company was insolvent at the time of the transfer. Obviously, reasonable minds can differ on the valuation of a company or its assets and the resultant solvency or insolvency of the company. Many such valuation contests naturally take the form of a "battle of the experts", with each side offering its own expert testimony about the appropriate discounted cash flow analysis, comparable companies metrics, etc.

However in many high-dollar sophisticated corporate transactions involving a leveraged buyout, spinoff or dividend, the subject company's management will have proactively tried to insulate the transaction against later challenge by preparing its own financial projections and obtaining an outside solvency opinion as evidence of its solvency at the time of the transaction. For example, *Minimizing the Risk of Fraudulent Transfer Avoidance: A Good-Faith Solvency Opinion as the Shield to Protect a Leveraged Transaction* offers specific tips for "bulletproofing a solvency opinion so as to reduce the risk of future avoidance on fraudulent conveyance grounds." Irina Fox, *Minimizing the Risk of Fraudulent Transfer Avoidance: A Good-Faith Solvency Opinion as the Shield to Protect a Leveraged Transaction*, 91 Am. Bankr. L.J. 739, 741 (Fall 2017).

The article laments that, while the merits of leveraged transactions cannot be second-guessed outside of bankruptcy under the business judgment rule standard, "no business judgment rule deference is available if the same decision is evaluated as a fraudulent transfer in an avoidance action. That same decision will be subject to heightened scrutiny, often with 20/20-hindsight serving as a prism through which the court will review the deal." and that "courts tend to accord no deference to the corporate decision makers, relying instead on ex post facto litigation experts and injecting impermissible hindsight bias into their decisions." *Id.* at 748-49.

But does recent bankruptcy case law support this notion, so that a party evaluating whether to mount a fraudulent conveyance challenge can proceed with the expectation that his valuation expert testimony will be on equal footing with the valuations undertaken by the defendant company?

We can safely assume that practically every company engaging in a high-dollar, sophisticated corporate transaction will carefully document a supposedly independent review of management projections and purchase "bullet proof" solvency opinions from supposedly independent outside financial advisors. In deciding whether to pursue a fraudulent conveyance action, which will take many months or years to litigate, the challenger must evaluate the effect of such financial projections and solvency opinions on the odds of success.

One case that offers much hope to parties challenging sophisticated corporate transactions is *Tronox Inc. v. Kerr McGee Corp.* (*In re Tronox Inc.*), 503 B.R. 239 (Bankr. S.D.N.Y. 2013). In *Tronox*, the bankruptcy court gave no deference to the company's business judgment or to the solvency opinions that the company obtained from outside financial advisors at the time of the transaction. *See id.* at 286-87. *Tronox* establishes an important precedent that a sophisticated corporate transaction fully papered by management's financial projections and an outside solvency opinion is nevertheless subject to avoidance as a fraudulent transfer.

But more recent case law suggests that the *Tronox* rejection of management's projections and solvency opinions, while remaining a viable theoretical precedent, is an aberration. Instead, more recent cases suggest that company management's financial projections and solvency opinions generated at the time of the transaction to support the transaction will in fact be accorded great deference.

Thus in *Weisfelner v. Blavatnik (In re Lyondell Chemical Co.)*, Judge Glenn stated that "Courts, however, have emphasized that solvency analysis should begin with a review of management's projections." 567 B.R. 55, 110 (Bankr. S.D.N.Y. 2017), *aff'd in part*, 585 B.R. 41 (S.D.N.Y. 2018) (citing *Comm. of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283, 347 (Bankr. S.D.N.Y. 2007) ("without a firm basis to replace management cost projections with those developed for litigation, the starting point for a solvency analysis should be management's projections) and *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995) (stating that for capital adequacy, "a court must consider the reasonableness of the company's projections, not with hindsight, but with respect to whether they were prudent when made")).

In contrast to the deference shown to company management projections, plaintiffs' expert valuation evidence is viewed as inherently suspect. Thus, Judge Glenn's *Lyondell* decision also cited *In re Citadel Broad. Corp*., No. 09-17442, 2010 Bankr. LEXIS 1606, 2010 WL 2010808, at *5 (Bankr. S.D.N.Y., May 19, 2010), which stated that "[t]here is no basis to replace management's informed judgments with those of [plaintiff's expert]." *In re Lyondell Chemical Co.*, 567 B.R. at 110.

Another recent decision, *Burtch v. Opus LLC* (*In re Opus East, LLC*), likewise concluded that:

> Such cash flow projections created by expert witnesses for litigation purposes are inherently suspect. *In re Emerging Commc'ns, Inc. S'holders Litig*., No. Civ. A.16415, 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at*15 (Del. Ch. June 4, 2004) (noting that "post hoc litigation-driven forecasts have an 'untenably high' probability of containing 'hindsight bias and other cognitive distortions.'") (citations omitted) . . . *Merion Cap., L.P. v. 3M Cogent, Inc.*, Civ. A. No. 6247-VCP, 2013 Del. Ch. LEXIS 172, 2013 WL 3793896, at *11 (Del. Ch. July 8, 2013) (courts presumptively favor management's projections that are created for business purposes).

528 B.R. 30, 55 (Bankr. D. Del. 2015), *aff'd*, 2016 U.S. Dist. LEXIS 42955 (D. Del. Mar. 31, 2016), *aff'd*, 698 F. App'x 711 (3d Cir. 2017).

These recent decisions, while not quite constituting the equivalent of a "business judgement rule" in favor of the defendant company on the issue of solvency, should certainly raise concern in the mind of any party seeking to avoid such a transaction as a constructive fraudulent transfer.

In conclusion, while the *Tronox* holding provides the party asserting a fraudulent transfer some hope that a company's management projections and solvency opinion will not be dispositive in establishing solvency, as a practical matter, it appears that projections created by company management and solvency opinions purchased from financial advisors to insulate the transaction from attack will be afforded substantially greater deference than projections and insolvency opinions created by challengers.

Can a fraudulent transfer challenge succeed if the market price of the company's stock had substantial value at the time of the transaction?

No matter how overleveraged, unprofitable, and liquidity constrained a company may be, it is generally impossible to convince a bankruptcy court to find that the company was insolvent at a time when the company's stock traded at a substantial positive value. The bankruptcy court will virtually always make the deduction that the fair market value of the company's assets must be greater than its liabilities if the stock trades at a substantial positive value.

Fortunately, parties seeking to recover fraudulent conveyances in such circumstances can once again point to the precedent of *Tronox*, in which the bankruptcy court rejected the stock market value as an all-knowing indicator that *Tronox* was a solvent entity. In *Tronox*, the court flatly rejected the market price of stock as evidence of insolvency on the grounds that the company's environmental liabilities had not been fully vetted by the market. *See In re Tronox Inc*., 503 B.R. at 298-301.

However, other recent fraudulent conveyance decisions involving a company with substantial positive stock price have deferred to the market as establishing solvency. Several of these decisions were discussed in Gregory Horowitz's article, *Contested Valuation in Corporate Bankruptcy: A Collier Monograph*. Gregory Horowitz, *Market Pricing in Solvency Valuation and Testing, in Contested Valuation in Corporate Bankruptcy: A Collier Monograph* 4-16 (LexisNexis 2011) [hereinafter Horowitz, *Market Pricing*]. The article noted that there were surprisingly few cases addressing the evidentiary value of contemporaneous market prices until 2007, when two cases were decided: *Iridium IP LLC v. Motorola, Inc*. (*In re Iridium Operating LLC*), 373 B.R. 283 (Bankr. S.D.N.Y. 2007) and *VFB LLC v. Campbell Soup Co*., 482 F.3d 624 (3d Cir. 2007). In *VFB*, the United States District Court for the District of Delaware and Third Circuit held that the fact that the subject company had a substantial positive stock price after the date of the challenged corporate spin off was determinative of the company's solvency. *VFB LLC*, 482 F.3d at 629-30. In *Iridium,* the court held that the market quote "remains the best and most unbiased measure of fair market value and, when available to the Court, is the preferred standard of valuation." *In re Iridium Operating LLC*, 373 B.R. at 293. The *Iridium* court thus found that the company was solvent "despite the fact that it was unable to generate sufficient revenue to service its debt and descended into a death spiral and collapsed into bankruptcy shortly after going into commercial service." *Id.* at 292. The court also supported its decision by noting that the lenders and underwriters had extended credit, implicitly endorsing the view that Iridium was solvent. *Id*. at 294 n.2.

The court ruling suggests that stock price is inherently superior to the litigation expert's valuation: "the public markets constitute a better guide to fair value than the opinions of hired litigation experts whose valuation work is performed after the fact and from an advocate's point of view." *Id.* at 291.

The logical response of the challenger asserting insolvency in the face of a positive market price is to argue that the market did not have access to the complete underlying information about the subject company's assets and liabilities. As Horowitz notes, "both the *Iridium* and *VFB* courts emphasized that they had not been given any reason to believe the market had been deprived of relevant information . . . It seems fair to presume that both of these courts were open to hear evidence that the public had been deprived of material information such that the market's judgment could not be relied upon as a true indicator of value." *See* Horowitz, *Market Pricing*, at 4-11, 4-12 (discussing *Iridium* and *VFB*).

But how realistic is it to believe that a challenger will be able to convince a bankruptcy court that the market was, in the absence of actual fraud by the company's officers, unaware of material information to properly value the company's assets or its liabilities? A typical outcome of such effort:

> Contrary to the Trustee's claims, the district court found that the evidence of Idearc's value based on the market price of Idearc stock was a reliable indicator of Idearc's value because the market was not misled. 2013 U.S.Dist. LEXIS 8521, [WL] at *10. Upon careful consideration of the evidence, the district court concluded that the information that the Trustee alleged was withheld from the market was actually disclosed or, if not disclosed, was not material. 2013 U.S. Dist. LEXIS 8521, [WL] at *10-29.

U.S. Bank N.A. v. Verizon Commc'ns, Inc., 761 F.3d 409, 432 (5th Cir. 2014).

Tronox however, was the atypical outcome: the court rejected the stock market's valuation and instead relied on the litigation expert's analysis; the court relied on an earlier 2002 decision determining the insolvency of a company that, like Tronox, was obligated for non-contractual liabilities. The *Tronox* court reasoned that "[i]n the *W.R. Grace* case, the fulcrum issue relating to insolvency was the size of its asbestos liability. In the instant case, it is the size of Tronox's environmental liability. In both cases, the market as a whole, no matter how efficient or inefficient, cannot be relied on to determine solvency or insolvency. In this case, as further discussed below, there is no substitute for a solvency analysis." *In re Tronox Inc*., 503 B.R. at 302-03.

The Market Pricing article pre-dated the ruling in *Tronox* but anticipated its ruling as a possibility; it observed that the *W.R. Grace* ruling in 2002, in which a finding of insolvency was based on asbestos claims that were unknown at the time of the challenged transfers:

> represents a potentially enormous exception to the principle that the company is solvent if judged to be so by an efficient and well-informed market. There was no suggestion in [*W.R. Grace*] that Grace had withheld any material information known to it about its asbestos liability at the time of the transaction . . . The ruling nonetheless stands for the proposition that future events may demonstrate that, by virtue of existing but unknown liabilities, a company was insolvent at any moment in time . . . Conceivably a litigant could seek to extend the logic of [*W.R. Grace*] to situations in which a company's assets were, at the time of the transaction, worth less than the company or market could have known because of some then present but as yet unknown fact.

Horowitz, *Market Pricing*, at 4-19.

However, the recent cases do not suggest that bankruptcy courts are extending the logic of *W. R. Grace* or *Tronox*. The general trend of cases is that, as a matter of principle, the market pricing of a company's stock is necessarily dispositive as a determination of its solvency. This trend is exemplified by the rulings in 2007 in *Iridium* and *VFB.* In fact, recent court determinations of solvency have stated the view that not only a substantial stock price, but also the willingness of third-party investors to extend credit to the company, justifies a finding of solvency.

For example, Judge Glenn wrote in his 2017 *Lyondell* decision:

> Here, the views of the financing banks are especially pertinent because these parties funded the Merger and, as "sophisticated investors with the most intimate knowledge of [LBI's] business plan and capitalization," they "had confidence in the company's future." *Davidoff*, 2005 U.S. Dist. LEXIS 17638, 2005 WL 2030501, at *11 (rejecting an allegation of capital inadequacy where "sophisticated investors . . . did not think that the company was undercapitalized"); see also *Kipperman v. Onex Corp*., 411 B.R. 805, 836-37 (N.D. Ga. 2009) ("Courts should also recognize that 'a powerful indication of contemporary, informed opinion as to value comes from private investors who with their finances and time at stake, and with access to substantial professional expertise, conclude at the time that the business was indeed one that could be profitably pursued.'") (quoting *Iridium*, 373 B.R. at 348). In *Iridium*, the court illustrated this concept…

In re Lyondell Chemical Co., 567 B.R. at 112.

Once again, it is worth noting the favorable precedent of *Tronox*, in which the court discounted not only the views of the stock market but also the fact that third-party investors were willing to extend credit to the company at the time of the transaction. Overall, while *Tronox* establishes the theoretical ability of the trier of fact to make a finding of insolvency notwithstanding contrary contemporaneous market data, recent cases suggest that most bankruptcy courts will refuse to do so.

Is "irrational exuberance" a basis for a court to discount market data showing solvency?

Finally, it should be noted that "irrational exuberance" of the overall market has been rejected as a basis for refusing to accept market data as dispositive of solvency. As noted in the Market Pricing article, the *Iridium* case at least seemed to leave open the possibility of the court accepting an irrational exuberance argument. The *Iridium* court stated it "is not bound to accept the value that has been ascribed to Iridium securities by the public markets and has the broad discretion to find that the markets somehow were distorted and did not fairly reflect the underlying enterprise value of Iridium…" *In re Iridium Operating LLC*, 373 BR at 303. But as the Market Pricing article points out, the *VFB* decision flatly stated: "Even if, as VFB implies, the market was suffering from some 'irrational exuberance' in establishing VFI's stock price, that gives me no basis for second-guessing the value that was fairly established in open and informed trading." *VFB LLC*, 482 F.3d at 630 (quoting district court Op. at 58).

In fact, it is instructive to note the repeated occurrence of "unforeseeable" macroeconomic developments that lead to various companies' downfall, with courts refusing to find them insolvent or inadequately capitalized for their inability to withstand such cycle. Judge Glenn's *Lyondell* decision noted the testimony about the most recent iteration of an economic downturn:

> Numerous witnesses testified that the Great Recession was not predicted by anyone, and was a strong contributing factor to LBI's ultimate downfall. (11/2 Trial Tr. (Jeffries) at 2289:19-23 ("Look, as we all know now, looking back in history, the events of 2008, none of us ever predicted. And it was probably—you know, from the financial crisis on down, it was probably the worst events any of us have seen since the Great Depression in the 30s.").

In re Lyondell Chemical Co., 567 B.R. at 83. Later in the opinion, the *Lyondell* court notes prior court decisions based on characterizations of earlier economic downturns as "unpredictable economic events" and "unforeseeable economic circumstances":

> *See, e.g., Fidelity Bond & Mortg. Co. v. Brand (In re Fidelity Bond & Mortg. Co.)*, 340 B.R. 266, 298-99 (Bankr. E.D. Pa. 2006) ("[E]conomic events [such as the economic crisis in Asia], which had a considerable negative impact on the [d]ebtor post-[m]erger, were not predictable. As a result, I cannot conclude, in hindsight, that the [p]rojections were unreasonable or that the [d]ebtor was left with an inadequate amount of assets to withstand such unforeseeable economic circumstances.") (internal citations omitted); *Peltz v. Hatten*, 279 B.R. 710, 746 (D. Del. 2002), *aff'd sub nom, In re Commc'ns, Inc.*, 60 F. App'x 401 (3d Cir. 2003) (finding it pertinent to a capitalization analysis that "the evidence show[s] that the capital markets unexpectedly dried up in the late summer of 1998" due to the Russian debt default).

Id. at 110.

A 'relatively small' market value of a company's stock will not be sufficient to establish solvency.

It should be noted that not every positive stock price of a company implies that such company is insolvent. We instinctively recognize that there is option value in any stock that has not yet been extinguished; but if the total outstanding stock value is "high enough", this implies that there is not mere option value but a market view that the company's assets are worth more than its liabilities. The Market Pricing article and a subsequent article entitled *A Further Comment on the Complexities of Market Evidence in Valuation Litigation* by Gregory Horowitz, provide a compelling argument for exactly how to calculate the specific stock market price required that actually establishes that a company was solvent. Thus, a party seeking to establish a fraudulent transfer should be able to persuade a bankruptcy court that a "relatively small stock valuation" does not in fact imply solvency. But in a situation where the stock value and/or the pricing of other securities indicate solvency, it will be difficult for a litigant to convince a bankruptcy court to make a finding of insolvency.

Is pursuit of a fraudulent conveyance based on inadequate capitalization a viable alternative to establishing insolvency?

A party seeking to establish the prerequisite for a fraudulent transfer may consider trying to demonstrate inadequate capitalization as a substitute for establishing insolvency. At first glance, the case law would seem to favor such an approach:

> Unreasonably small capital claims. The leading case dealing with such claims is *Moody v. Security Pacific Business Credit*, *Inc.*, 971 F.2d 1056 (3d Cir. 1992). According to the Third Circuit in *Moody*, "unreasonably small capital denotes a financial condition short of equitable insolvency." *Id.* at 1070 . . . The Third Circuit went on to reason that, [v]iewed in this light, an "unreasonably small capital" would refer to the inability to generate sufficient profits to sustain operations. Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable insolvency.

Whyte v. Ritchie SC Holdings LLC (*In re Semcrude, L.P.*), 526 B.R. 556, 560 (D. Del. 2014), *aff'd*, 648 Fed. App'x 205 (3d Cir. 2016).

But case law quickly limits what at first glance appears to be an easier evidentiary burden:

> The difference between insolvency and "unreasonably small" assets in the LBO context is the difference between being bankrupt on the day the LBO is consummated and having at that moment such meager assets that bankruptcy is a consequence both likely and foreseeable . . . But one has to be careful with a term like "unreasonably small." It is fuzzy, and in danger of being interpreted under the influence of hindsight bias. One is tempted to suppose that because a firm failed it must have been inadequately capitalized. The temptation must be resisted.

Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 794 (7th Cir. 2009).

Recent decisions suggest that courts indeed resist finding inadequate capitalization in a situation where the court's test for solvency is met. Frequently, the court's capital adequacy test becomes almost identical to the solvency test based on the "reasonableness" of management projections and market data in the form of third party offers to extend credit. Indeed, the *Lyondell* court noted:

> These valuation principles regarding professional investors and stock prices are applicable to this Court's balance-sheet insolvency analysis, but also to a capital adequacy analysis, given that a number of reputable banking institutions determined that supplying the capital for the Merger on a secured basis was a prudent investment.

In re Lyondell Chemical Co., 567 B.R. at 112.

So while a challenge based on capital inadequacy may be worth pursuing, it is likely not a solution in a situation where the bankruptcy court would otherwise be expected to make a finding of solvency, based on management projections, solvency opinions, and market data.

A party challenging a sophisticated corporate transaction as a fraudulent transfer should consider seeking a trial by jury instead of trial by the bankruptcy court.

Given the great deference bankruptcy courts give to management projections, solvency opinions, and market data, a party seeking to avoid a transaction as a fraudulent transfer should seriously consider seeking a jury trial. While most fraudulent conveyance actions involving debtors in bankruptcy are tried by the bankruptcy court without a jury, the debtor-in-possession or trustee of the bankruptcy estate is frequently entitled to a jury on at least its state law fraudulent conveyance claims. This right is not lost simply by the debtor filing bankruptcy. However, in certain circumstances, the trustee's right to a trial by jury trial may be lost to the extent that the fraudulent conveyance defendant has filed a proof of claim and resolution of that fraudulent conveyance exposure is necessary to the resolution of the proof of claim or to the resolution of the Chapter 11 case.

A recent article describes the conflicting circuit court rulings on whether or not the trustee or party asserting the rights of the bankruptcy estate retains the right to a jury trial for common law claims. *See* Katie Drell Grissel, *The Supreme Court Is Not Ready to Tell Us When a Trustee or Debtor-in-Possession Possesses Seventh Amendment Jury Trial Rights in Bankruptcy… Here Is What We Know in the Meantime*, 26 Am. Bankr. Inst. L. Rev. 333, 349-363 (Summer 2018) [hereinafter Grissel, *The Supreme Court*]. Such common law claims could include, for example, state law fraudulent conveyance claims.

As context for its discussion of the competing circuit court rulings, the article notes the ruling of the Supreme Court in *Stern v. Marshall* and its reasoning that a counterclaim, similar to a fraudulent conveyance claim, is a state common law claim and must be resolved by Article III courts. *Id.* at 343-44 (citing *Stern v. Marshall*, 564 U.S. 462, 493 (2011)). Additionally, the article notes that *Stern v. Marshall* is not inconsistent with the earlier Supreme Court rulings in *Katchen v. Landy*, 382 U.S. 323 (1966) that a bankruptcy court has authority to resolve a creditor's proof of claim to the extent that the creditor has filed a proof of claim voluntarily in the bankruptcy case, and in *Langenkamp v. Culp*, 498 U.S. 42 (1990) (per curiam), *reh'g denied*, 498 U.S. 1043 (1991) that a defendant had no right to a jury trial where it had filed a proof of claim and was being sued for preferential transfers–but where the defendant had not filed a proof of claim, its jury trial right was preserved. Grissel, *The Supreme Court*, at 340.

The courts in the Sixth and Seventh Circuits have ruled in the context of non-dischargeability actions brought against debtors, that the trustees and debtors-in-possession lose their jury trial rights once they file a voluntary bankruptcy. *See N.I.S. Corp. v. Hallahan (In re Hallahan)*, 936 F.2d 1496, 1505-07 (7th Cir. 1991); *Longo v. McLaren (In re McLaren)*, 3 F.3d 958, 960-61 (6th Cir. 1993).

However, courts in the Second, Third, and Fifth Circuits hold that, depending on the circumstances, the jury trial right of the trustee or debtor in possessions continues to exist even after a bankruptcy filing. In *Germain v. Conn. Nat'l Bank (In re Germain)*, the Second Circuit held that the trustee retained its jury trial right to sue a creditor bank for lender liability, even though the creditor bank had filed a proof claim. 988 F.2d 1323, 1329-30 (2d Cir. 1993). The court ruled that the lender liability action would not affect the allowance of the creditor's claim, so that there was no basis for loss of the right to a jury trial. *Id.*

The Second Circuit later elaborated on its analysis, noting that its opinion in *Germain* "does not alter the well-established principle" that no jury trial right existed where the claims are "integral to, and directly affect the allowance of, the proof of claim [] filed with the bankruptcy court." *Bankruptcy Services, Inc. v. Ernst & Young (In re CBI Holding Co., Inc.)*, 529 F.3d 432, 468 (2d Cir. 2008).

The Fifth Circuit has held that a trustee initially retains any right to a jury trial, subject to losing it to the extent its adversary loses its own jury trial right by virtue of filing a voluntary proof of claim in the bankruptcy. *See U.S. Bank N.A.*, 761 F.3d at 418-22 ("Since the Trustee stands in the shoes of [the debtor] . . . for the purposes of this litigation, and since [the debtor] would have no Seventh Amendment right to a jury trial, the Trustee also lacks such a right.").

The Third Circuit has likewise held that there is no automatic loss of a right to a jury trial on state law claims once a debtor enters bankruptcy, but that such right could be lost if the resolution of the claims was integral to the process of allowance or disallowance of proofs of claims made in the bankruptcy case. *Billing v. Ravin, Greenberg & Zackin, P.A.,* 22 F.3d 1242, 1253 (3d Cir. 1994) (holding that the "debtors have no Seventh Amendment right to trial by jury, not because of specific waiver of Seventh Amendment rights, but because their claim has been converted from a legal one into an equitable dispute over a share of the estate.").

Conclusion

In the next inevitable downturn there will likely be a large number of bankruptcies of highly leveraged companies that have for the last several years enjoyed the benefits of historically low interest rates and historically "covenant light" loan agreements. These covenant-free loans have allowed these companies to engage in substantial asset transfers that might have been prohibited during less "covenant-light" times. We can expect that the vast majority of these transfers and distributions will have been carefully papered by company management's financial projections, and blessed by solvency opinions purchased from "independent" outside financial advisors. Regardless of the merits of a fraudulent conveyance action challenging such transactions, prevailing on such actions will be an uphill battle in the bankruptcy court.

However, the ultimate determination of whether a fraudulent transfer has occurred is largely a matter of fact and not a matter of law. With the precedent set by *Tronox* and *W.R. Grace*, any finder of fact should have considerable authority to reject management projections, solvency opinions, and even market data to the extent that the finder of fact finds other evidence more persuasive. Any party asserting a fraudulent conveyance should consider tailoring its challenge to enlist the jury as the trier of fact if such party is pessimistic about its chances of success before a bankruptcy judge.